Europe Economic Research 06 February 2025

Euro wrap-up

Overview

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- Bunds made modest losses as German new factory orders surprised to the upside in December and euro area retail sales suggested positive consumption growth in Q4.
- Despite an initial rally after the BoE cut rates by 25bps and two MPC members voted for a 50bps cut, Gilts closed the day lower as the BoE revised up significantly its near-term inflation projection and highlighted the uncertainty of the outlook.
- Friday will bring December figures for German and Irish industrial production and German and French trade.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 03/27	2.050	+0.004
OBL 2.4 04/30	2.161	+0.009
DBR 2½ 02/35	2.375	+0.012
UKT 4⅛ 01/27	4.160	+0.022
UKT 4⅛ 07/29	4.171	+0.052
UKT 4¼ 07/34	4.484	+0.049

*Change from close as at 5.00pm GMT.
Source: Bloomberg

UK

BoE cuts Bank Rate by 25bps, two MPC members vote for 50bps, but uncertainty highlighted

As expected, the BoE's MPC cut Bank Rate by 25bps to 4.50%, the lowest level since June 2023. This represented the third cut of that magnitude at a three-month interval this cycle. But it left Bank Rate still very much in restrictive territory. Seven members of the MPC voted for the cut of 25bps. But two members – predictably the uber-dove Dhingra and more surprisingly the previous uber-hawk Mann – voted for cuts of 50bps. While that vote appeared to provide a dovish bias to the decision, the two dissenters had contrasting perceptions of the inflation outlook and the full extent of easing required over coming months. More importantly, the MPC's forward guidance reiterated that policy will remain restrictive for 'sufficiently long until the risks to inflation returning sustainably to the 2% target in the medium term have dissipated further'. And the tone of the MPC minutes and Monetary Policy Report, as well as Governor Bailey's post-meeting comments, were measured, highlighting the uncertainty of the outlook and the wide range of views on the committee.

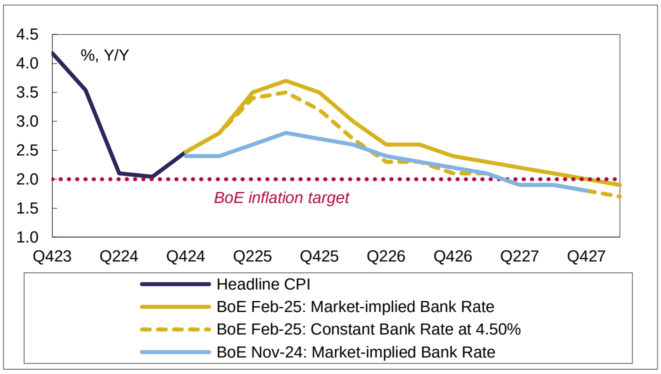
MPC states case for 'gradual and careful' easing

As at recent meetings, the MPC's statement stated that a 'gradual' approach to the further withdrawal of monetary policy restraint remains appropriate. And Bailey underscored that he still expects the path for rates to continue to be down. But, as we expected, he also emphasised that two-sided uncertainty had increased for both domestic and external reasons. And given those increased risks to the outlook, the MPC's guidance added that the further withdrawal of monetary restraint will be 'careful'. The value of inserting that extra word is debatable. After all, considering the alternative, we would never expect the MPC to be 'careless'. And so, while we agree that the outlook is more uncertain, our baseline forecast maintains further cuts in Bank Rate of 25bps each quarter this year and into 2026.

BoE judges that underlying disinflation continues despite big upwards revision to CPI outlook

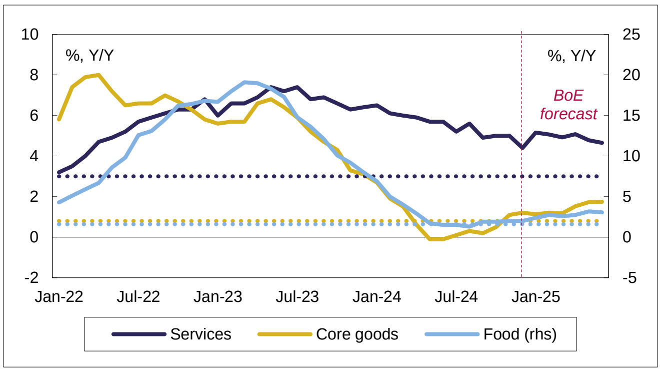
The assessment that further monetary easing will remain appropriate reflected the MPC's view that underlying disinflation in domestic prices – particularly in services – and wages continues. But the BoE inevitably revised up its near-term inflation outlook, principally to reflect higher wholesale energy prices, which have risen in response to colder European winter weather. Inflation of food and core goods is also expected to be higher over the near term due in part to the recent weakness of sterling. So, the near-term peak in inflation in Q325 is now judged to be 3.7%Y/Y, up 1.2ppt from Q424 and a hefty 0.9ppt more than projected by the Bank in November. Thereafter, however, inflation is expected to continue to decline to around 2½%Y/Y between Q2 and Q4 2026, and gradually further thereafter to 2.0%Y/Y by end-2027.

UK: BoE projections – CPI inflation



Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: BoE projections – key inflation components*



**Dotted lines represent average between 2010-2019.*
Source: BoE and Daiwa Capital Markets Europe Ltd.

GDP growth projection for 2025 halved but outlook thereafter little changed

That renewed downwards path in inflation from Q425 on reflects the weakness of economic activity, which has flatlined since the spring and is now expected to remain subdued for a while yet. Indeed, the BoE revised down its GDP outlook very significantly. After a contraction of 0.1%Q/Q in Q4, the BoE expects GDP to rise this quarter by just 0.1%Q/Q, 0.3ppt less than it expected in November. And while momentum is expected to rebuild again as the year goes on thanks to firmer household consumption, business investment and government spending, it halved its GDP growth projection for 2025 to just ¾%Y/Y. Thereafter, however, it nudged up marginally its projection of growth in 2026 and 2027 to 1½%Y/Y.

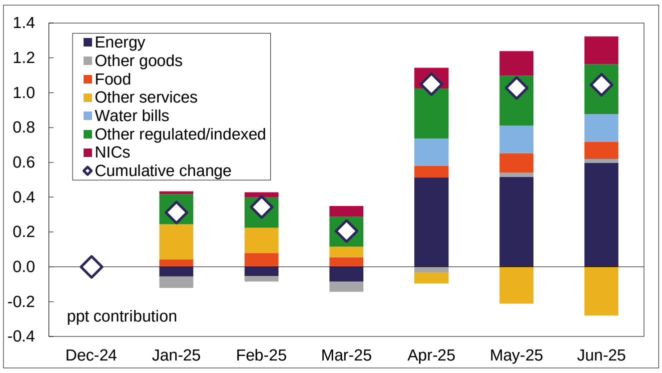
Is weakness of economic activity due more to supply or demand factors?

Given the weakness of that profile for activity, a margin of economic slack is expected to emerge gradually from this year on, weighing a little further on underlying price pressures to secure the return of inflation to target by the end of the horizon. However, Bailey made clear in his press conference that the BoE still does not understand whether the recent weakness of economic activity relates more to demand or supply factors. MPC members appear to have differing views on the matter. But the balance between those two factors – as well as the nature of any incoming shocks such as those that might be related to US tariff policies – will ultimately determine the extent and pace of further disinflation and further monetary easing over the coming couple of years.

Scope for ongoing gradual easing into 2026 in the absence of new supply deterioration

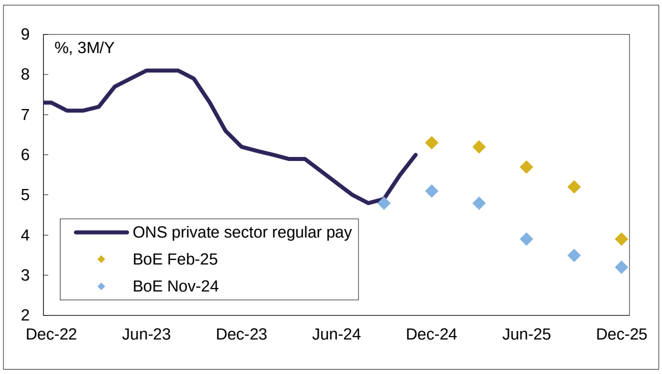
Notably, the BoE now thinks supply growth has recently weakened to a greater extent than previously expected. As such it revised up significantly its projection for private sector wage growth this year despite a simultaneous upwards revision to its unemployment rate forecast. Despite an upwards revision to its estimate of potential labour supply but due to deterioration in productivity, its updated projections incorporate a notable slowdown in overall four-quarter potential supply growth from around 1½%Y/Y at the start of 2024 to around ¾%Y/Y at the start of this year. In part thanks to an assumption that productivity growth will pick back up, potential supply growth is then projected to rise back to around 1½%Y/Y in the medium term. But if the BoE is correct about the recent weakness of potential supply, and supply-side deterioration persists whether due to domestic or external factors, Bank Rate will likely remain close to or above the path currently priced into markets. We think that the supply-side deterioration might be exaggerated by measurement difficulties and that demand-side factors – associated not least with weak confidence – might have been more important than the BoE estimates so that slack is already picking up. We expect that to lead to a faster pace of disinflation than is incorporated in the MPC's updated projections. And as we also expect GDP growth to remain weaker for longer, our baseline projection continues to foresee a return of Bank

UK: BoE projected cumulative change in inflation*



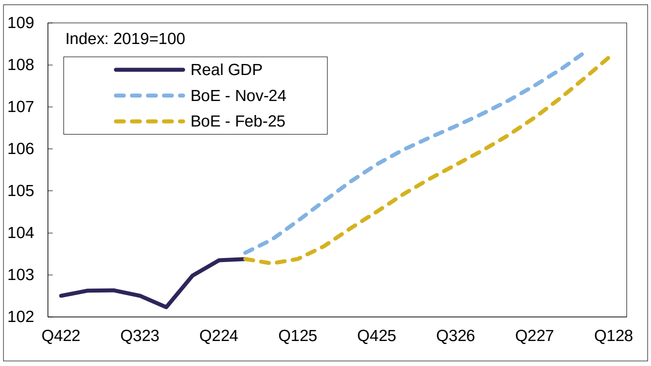
*Since December 2024. Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Private sector regular pay



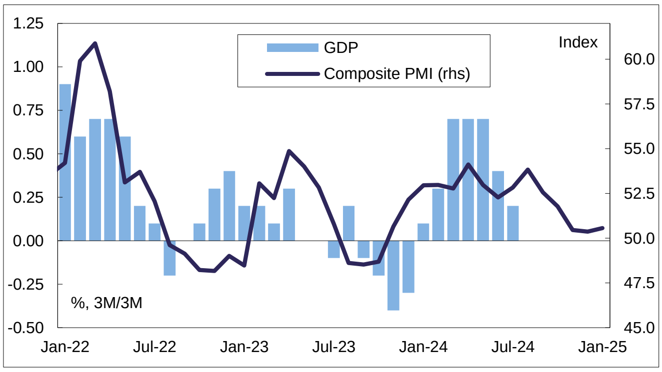
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: BoE projections – real GDP levels*



*Based on market implied interest rates.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite PMI



Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Rate by H226 to 3.25%, a little above the centre of the BoE's updated (upwardly revised) range of model-based estimates of neutral, also published today. But, like Bailey, we also acknowledge the significant two-sided risks to the UK outlook.

The day ahead in the UK

Following today's monetary policy announcements, attention tomorrow will turn to BoE Chief Economist Pill's briefing to stakeholders on the latest Monetary Policy Report.

Euro area

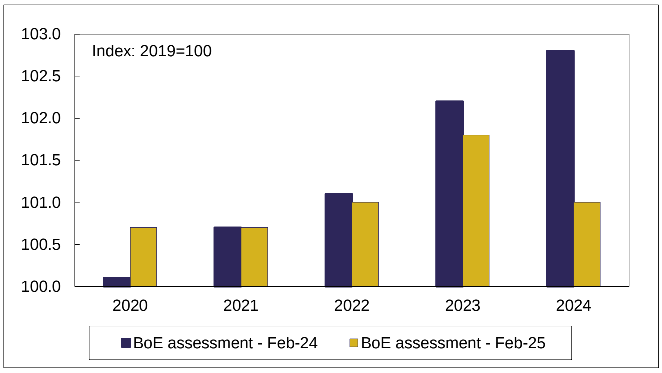
Euro area retail sales grew in Q4 but weakened heading to year-end

While the first estimate of euro area GDP suggested that economic output moved sideways in the final quarter of 2024, national accounts from Germany, France and Spain suggested that household consumption provided a positive contribution to growth for a third quarter out of the past four. This tallied with today's euro area retail sales figures, which reported a fifth consecutive quarterly rise of 0.4%Q/Q in Q4, albeit notably softer than growth in Q3 (1.1%Q/Q). Growth in core spending (i.e. sales excluding food and fuel) was also positive in Q4 (0.6%Q/Q). But this principally reflected a strong carryover from September. Indeed, the recent monthly profile showed total sales declining in two out of the three months of Q4, including a drop of 0.2%M/M in December. Admittedly, the weakness that month was driven by food sales (-0.7%M/M). And the decline was most prominent in Germany (-1.6%M/M), contrasting with positive growth in Italy (0.3%M/M), Spain (1.4%M/M) and Portugal (0.7%M/M). However, the near-term spending outlook remains fragile, not least given households' continued preference to boost savings in the face of rising uncertainty.

German new factory orders boosted by shipping order, but underlying demand also improved

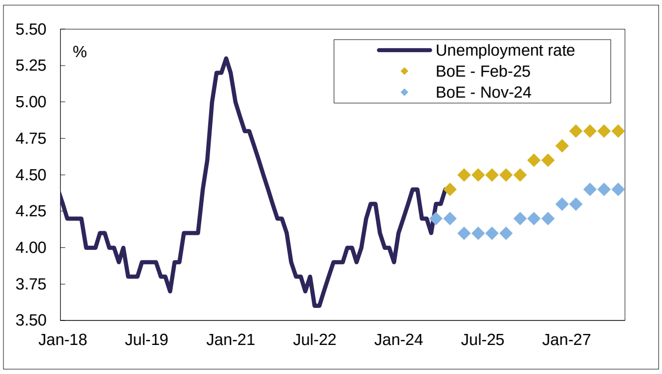
Despite the marked decline in German retail sales in December, they still rose for a third consecutive quarter in Q4 (0.6%Q/Q). Services sales in November were similarly trending some ½% above the Q3 average. And construction activity in October and November was merely in line with the Q3 average. So, the contraction in economic activity in Q4 appears to have been largely driven by continued weakness in manufacturing. Indeed, factory output in the first two months of Q4 was more than 1% lower than in Q3, pointing to a sixth quarterly decline in seven. At face value, today's factory orders data were more encouraging, rising a stronger-than-expected 6.9%M/M in December. Admittedly, this merely reversed declines in previous months to be flat over the fourth quarter as a whole. And the bounce back in December was in part due to a jump in 'other transport equipment' (55%M/M) relating to a sizeable domestic ship order. Nevertheless, contrasting a further drop in

UK: BoE assessment of potential productivity*



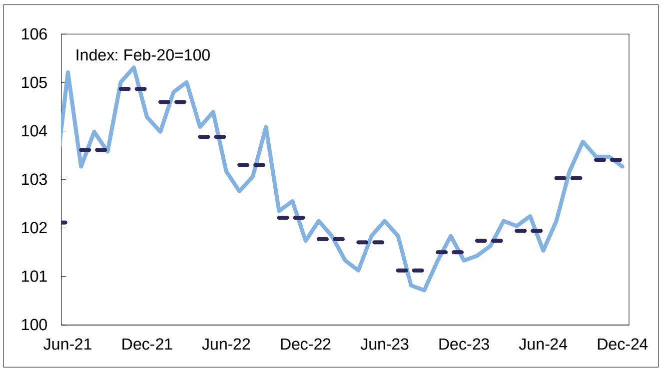
**Per hour. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: BoE projections – unemployment rate*



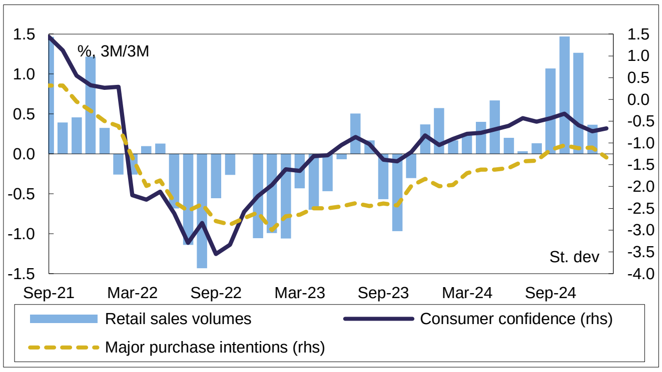
**Based on market implied interest rates.*
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales*



**Dashed dark blue lines represent quarterly average.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales & consumer confidence



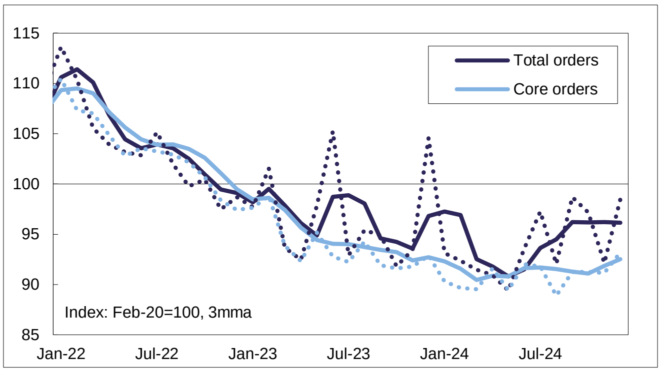
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

new car orders – to the lowest level in seven months – there was also renewed demand for machinery, computers, electronic and optical products, pharmaceuticals and clothing. Indeed, when excluding bulk items, core orders rose 2.2%M/M, to leave them up 1.3%3M/3M, the most in six months amid a notable pickup in intermediate (2.1%3M/3M) and consumer goods (3.2%3M/3M), suggesting a tentative pickup in underlying demand.

Manufacturing outlook remains tainted by significant uncertainties

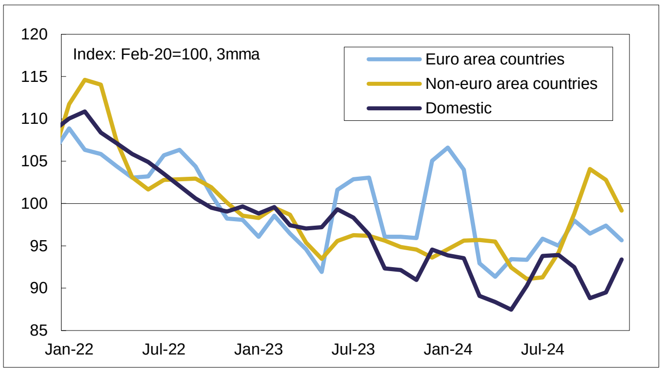
Recent signals on manufacturing production have, however, been mixed. Today's turnover figures were better than expected, falling just 0.1%M/M in December following a rise of 1.4%M/M in November. But this reflected a significant jump in energy. In contrast, turnover of intermediate and capital goods fell back at the end of last year, tallying with a notable deterioration in sentiment. Indeed, according to the ifo institute, manufacturers were the most downbeat about production in December in six months. According to the VDA, car production was also the weakest in any December since the series started in 2005. As such, tomorrow's industrial production figures for December are expected to report a decline of a little more than ½%M/M, with payback in both manufacturing and construction output after a strong rise in November. And notwithstanding a modest improvement signalled at the turn of the year, manufacturers were increasingly downbeat about the outlook due to heighted economic and political uncertainties, competitiveness challenges and concerns about US trade policies. Overall, we expect a meaningful recovery in manufacturing to remain elusive over coming quarters.

Germany: Factory orders*



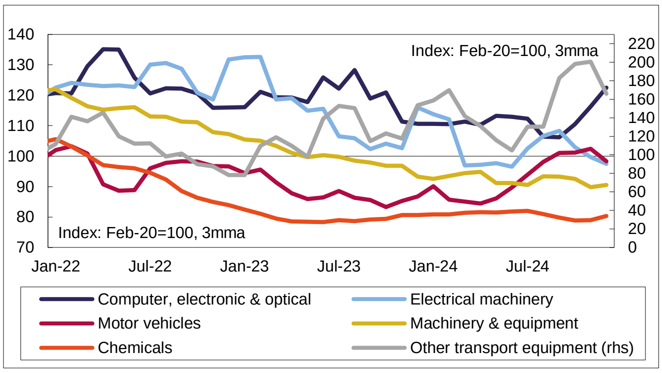
*Dotted lines represent unsmoothed data. Core orders excluding major orders.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Factory orders*



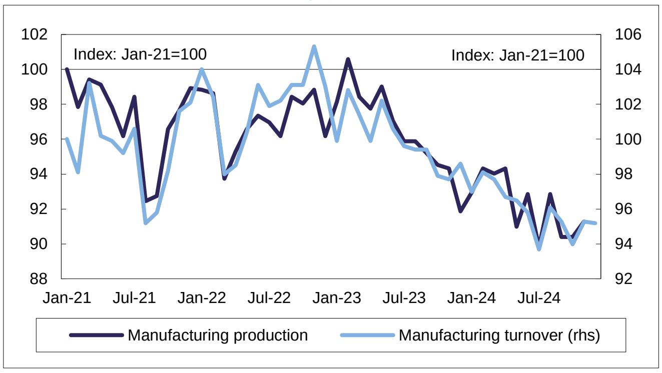
*Includes major orders.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Factory orders by subsector



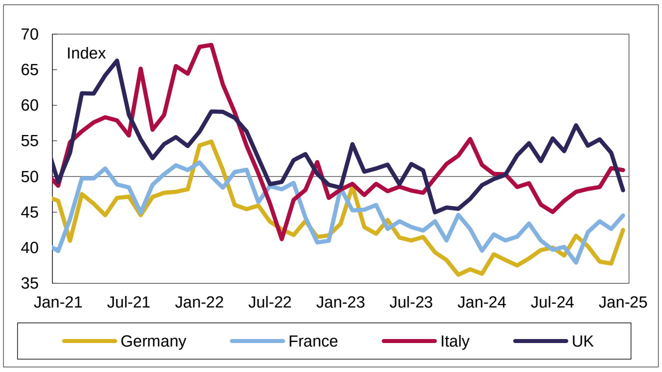
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing production & turnover



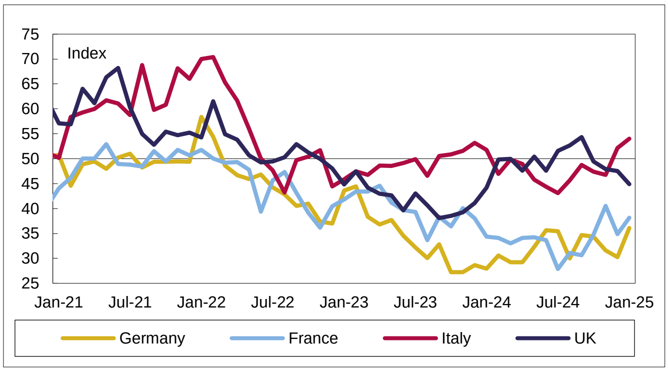
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Europe: Headline construction PMIs



Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Housing activity PMIs



Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Construction activity PMI jumps to a 20-month high despite subdued orders

Contrasting the downbeat manufacturing outlook, but consistent with the signals from the Commission's survey, today's PMIs suggested that conditions in the euro area's construction sector are gradually turning for the better, benefiting from a pickup in house prices and lower borrowing costs. Indeed, while still below the pre-pandemic average, the headline activity index jumped 2.5pts to 45.4 in January, the highest in almost two years. The improvement at the start of the year was most pronounced in Germany, where the respective PMI (42.5) was the highest in 20 months, albeit still the softest of the large member states. The French PMI (44.5) was also the best in 16 months, while the Italian index (50.9) remained consistent with ongoing modest expansion. While the improvement was also broad-based, the housing activity index (41.6) was the firmest since May 2023. And despite still subdued orders and higher input costs, constructors were the most upbeat about the outlook for the coming year since June.

The day ahead in the euro area

Following today's pick-up in manufacturing orders, one focus in the euro area at the end of the week will be the aforementioned German IP data for December. Following November's uptick in output, which was partly supported by a rebound in energy production, some payback that month would be consistent with the gloomy industrial surveys at the end of 2024, to leave output down for a sixth quarter out of the past seven. This will provide insight into the euro area production figures (due next Thursday), as will tomorrow's IP releases from Spain and Ireland, the latter of which is often prone to dramatic swings which can tilt the aggregate print. Meanwhile, Friday will also bring German and French trade data for December. In addition to the economic data, the ECB will publish a report of its latest range of estimates for the neutral interest rate. However, as Chief Economist Lane asserted during his foreside chat on Wednesday, these estimates will not provide precise guidance for near-term monetary policy decisions.

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Retail sales M/M% (Y/Y%)	Dec	**-0.2 (1.9)**	-0.1 (1.9)	0.1 (1.2)	0.0 (1.6)
	Construction PMI	Jan	**45.4**	-	42.9	-
Germany	Factory orders M/M% (Y/Y%)	Dec	**6.9 (-6.3)**	1.8 (-10.6)	-5.4 (-1.7)	-5.2 (-1.4)
	Construction PMI	Jan	**42.5**	-	37.8	-
France	Construction PMI	Jan	**44.5**	-	42.6	-
Italy	Construction PMI	Jan	**50.9**	-	51.2	-
UK	BoE Bank Rate %	Feb	**4.50**	*4.50*	4.75	-
	DMP 3M output price (1Y CPI) expectations %	Jan	**3.9 (3.0)**	3.9 (3.0)	3.8 (3.0)	-
	Construction PMI	Jan	**48.5**	53.5	53.3	-

Auctions

Country	Auction
France	sold €8.64bn of 3.2% 2035 bonds at an average yield of 3.15%
	sold €1.59bn of 1.25% 2036 bonds at an average yield of 3.2%
	sold €1.6bn of 1.25% 2038 bonds at an average yield of 3.33%
	sold €1.17bn of 3.25% 2055 bonds at an average yield of 3.66%
Spain	sold €2.59bn of 2.4% 2028 bonds at an average yield of 2.388%
	sold €1.74bn of 3.1% 2031 bonds at an average yield of 2.705%
	sold €1.87bn of 4% 2054 bonds at an average yield of 3.691%
	sold €570mn of 1.15% 2036 inflation-linked bonds at an average yield of 1.23%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases							
Economic data							
Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	Industrial production M/M% (Y/Y%)	Dec	-0.7 (-2.1)	1.5 (-2.8)
		07.00	Trade balance €bn	Dec	17.0	19.7
France		07.45	Trade balance €bn	Dec	-	-7.1
		07.45	Wages – first estimate Q/Q%	Q4	0.3	0.4
		07.45	Private sector payroll employment – first estimate Q/Q%	Q4	-0.1	0.1
Spain		08.00	Industrial production M/M% (Y/Y%)	Dec	0.3 (0.7)	-0.8 (-0.4)
Auctions and events						
Euro area		-	ECB to publish report on range of estimates of neutral interest rate			
UK		12.15	BoE Chief Economist Pill to brief Bank's Agents on updated macroeconomic projections			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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